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Splitting Up Ownership to Ride Out a Rough Spot

Partial Interest in Commercial Properties Is Becoming More Common in Manhattan

By MATT HUDGINS

It is not obvious from the names on the deeds, but 655 Madison Avenue, the Backer Building at 136 Madison Avenue and 304 East 45th Street in Manhattan share a new owner.

All three office buildings still belong to the joint ventures that have owned them for years, but in January a real estate private equity company, Madison International Realty, paid nearly $80 million to acquire ownership stakes in those partnerships. Madison bought the positions from the Irene Diamond Fund, which needed to liquidate its part in the portfolio to support its philanthropic activities.

Such "partial interest" deals, as they are known, are becoming more common in Manhattan, as they allow landlords to retain some control over properties that might otherwise revert to lenders through default and foreclosure when the final, balloon mortgage payment comes due. (Commercial loans are typically not self-amortizing.)

"Most of the real estate business is about ego and control, and if you talk to most of the usual suspects, they want to go out and buy buildings," said Ronald Dickerman, Madison's president and founder. "But we've created a really interesting business out of buying these partial interests in a private and underexposed niche of the commercial real estate business."

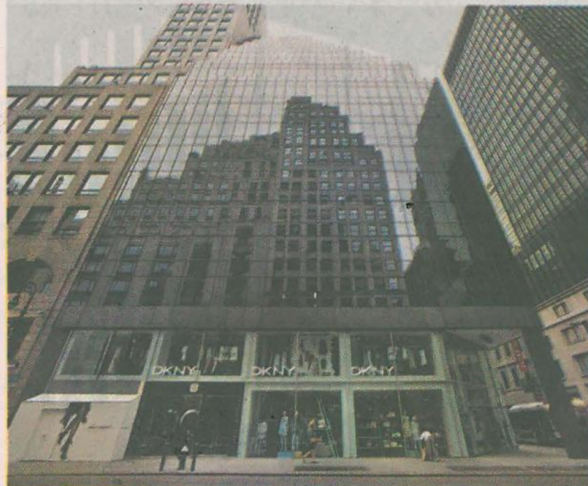
Partial-interest deals accounted for $9.9 billion, or 63 percent, of the $15.7 billion in Manhattan office transactions in 2011, according to Real Capital Analytics, a market researcher based in New York. That percentage is up sharply since the height of the market in 2007, when partial-interest deals made up less than $5.7 billion, or 19 percent, of Manhattan's $30.3 billion in office deals for the year.

Many of today's transactions are recapitalizations, in which the property owner uses an outside investor's capital and credibility to persuade the lender or lenders to restructure the property's debt. In exchange, the new investor typically gains equity, or an owning interest in the property. Often requiring lengthy negotiations among lenders and other stakeholders, the resulting deals usually bring the new investor into the existing ownership structure.

That is how Vornado Realty Trust acquired its 49.5 percent stake in the office part of 666 Fifth Avenue late last year. Kushner Companies had bought the 1.45 million-square-foot 39-story property for $1.8 billion in January 2007, but by the spring of 2010 Kushner was already negotiating with a special servicer to make the debt more manageable. Last December, Kushner and Vornado announced a joint venture that modified the $1.215 billion mortgage and extended its term until February 2019. In addition to taking on the debt, Vornado reported that it had invested $80 million in the venture.

The growing frequency of partial-interest transactions also explains why many so-called vulture investors, which have amassed funds to snatch up office buildings from distressed owners forced to sell at a loss, are still waiting on the sidelines for properties to show up on the auction block.

"These recapitalizations are the reason there isn't blood on the streets," said Dan Fasulo, the managing director at Real Capital Analytics, "and all this is taking place behind the scenes. That's going to be a template going forward."



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Madison International has acquired stakes in three Manhattan buildings, including 655 Madison Avenue, above, and the Backer Building, below.

Other recent examples include the purchase in May by Crown Acquisitions of a 49.9 percent interest in the Olympic Tower complex at 641 Fifth Avenue. In March, the Paramount Group, a privately held real estate investment manager, bought out Investa Office Fund of Australia's 49 percent stake in 900 Third Avenue to consolidate Paramount's ownership of the 604,000-square-foot office building

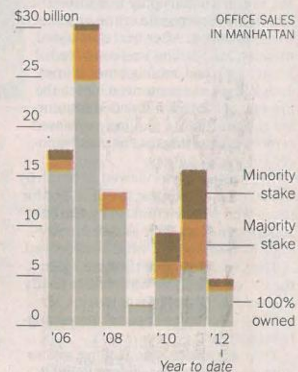
Of the 98 Manhattan office transactions that have closed since the beginning of 2010 for properties valued at $100 million or more, 40 involved partial-interest deals or recapitalizations, Real Capital's data shows.

Three distinct market forces will keep the recapitalization fires burning for at least the next few years, said Jay Neveloff, a partner at Kramer Levin Naftalis & Frankel in New York. One is the plentiful supply of capital that investors are eager to place in New York's promising real estate properties.

The other two are maturing commercial mortgages, which must be paid off and replaced with new financing, and conservative lending practices. In 2006 and 2007, lenders were commonly financing as much as 90 percent of an office property's value, but both loan-to-value ratios and asset values have come down since then. This creates shortfalls as investors seek financing to replace debts obtained before the financial crisis.

"It's hard to find new lenders that will refinance buildings at the same level today," Mr. Neveloff said. "The lender might say, 'We will consider extending the loan, but we want the principal reduced.' That's a great opportunity for some of the abundant money on the sidelines to come in and invest in the property."

Investors might prefer to buy office buildings outright, but few Manhattan owners are marketing their properties for sale. One possible deterrent to conventional sales is transfer tax, which the seller must pay upon selling 50 percent or more of a property.



The combined city and state transfer tax in Manhattan is 3.025 percent, one of the highest rates in the nation. The frequency of 49 percent office trades in recent months suggests that sellers are well aware of this tax trigger and are taking steps to avoid that cost through partial-interest transactions.

At a time when governments are facing deficits, the increase in partial-interest transactions means that millions of dollars invested in the New York office market this year will not be subject to transfer tax, said J. D. Parker, a vice president and regional manager in the Manhattan office of Marcus & Millichap Real Estate Investment Services. "A lot of people will buy up to 49 percent of a deal so they won't be subjected to that tax," Mr. Parker said. "That's a legitimate concern for the local and state economy."

Yet the situation is temporary, he believes. Once job growth brings increased demand for office space, rents and property values will begin to climb, making it easier for owners to finance their buildings or garner healthy sale prices. At that point, most investors will abandon the complexities of partial-interest investments and return to the relative simplicity of buying and selling entire properties.

"It's a necessary form of capital event that is required right now in the marketplace," Mr. Parker said, "but the market would prefer, at all points in the cycle, to be less complicated."

Madison, the new part-owner of 655 Madison and the other assets it bought stakes in earlier this year, has invested millions of dollars in partial-interest real estate transactions around the globe, and plans to keep doing so. But Mr. Dickerman, the company's president, agrees that the herd of investors making similar transactions today will ditch the partial-interest investment model once market conditions change.

"They'd rather own the buildings than buy partial interests in buildings," he said, "so I believe it's a bit of a passing fancy."